ISSUE: PROVIDE TAX INCENTIVES FOR PRESERVATION?

Issue: The tax on minimum gain is acknowledged to be the primary barrier to the preservation of pre-1986 affordable housing. The use of the tax code is by far the most direct and efficient means for removing the barrier. Absent a tax-based solution, this barrier will continue to create enormous inefficiency in both the housing and tax sectors. See the Preservation Tax Incentive background paper.

Why It Is A Problem: Some of the affordable stock faces conversion risk because of expiring affordability restrictions. Some of the stock faces capital needs risk because of major repairs and replacements that are needed but that cannot be financed while maintaining the property's affordability. Some of the stock is owned by entities that are not willing, and/or are not capable, to preserve the housing for long-term affordable housing use. Preservation therefore usually requires governmental subsidies and will often require a transfer of ownership. Under the *status quo*, in general a seller will not sell unless the price covers its tax liability, and often such a price will exceed the property's real estate value. Preservation purchasers typically pay the seller's price, in order to preserve the property. However, this is an inefficient approach in that purchasers can only estimate the seller's tax liability. A tax-based solution would be much more efficient and accurate.

The Potential Solution. The Task Forces considered recommendations for some form of preservation tax incentive. In general, the incentive would work in the following manner. The seller of an eligible property (which must be both "at-risk" and "preservation-worthy") would agree to sell the property to a desirable owner ("preserving entity") who agrees to a long-term affordable housing commitment ("use agreement") and who agrees to finance and operate the property in a way that assures its long-term physical and financial viability ("sustainability"). The seller would not be subject to federal income tax with respect to some or all of the seller's minimum gain. This would create an economic incentive for the sale of eligible properties for long-term affordable housing use. It would also be intended to make a preservation-oriented sale preferable to a sale that did not include long-term preservation as affordable housing.

Primary Recommendation: The Task Forces recommend the creation of a preservation tax incentive for the long-term preservation of HUD- and RHS-assisted properties, as outlined below.

1. **Eligible Properties.** The Task Forces recommend that relief be limited to existing properties developed before 1986 and assisted through HUD or the Rural Housing Service.
    - 1.1. **At Risk.** The Task Forces consider the entire eligible universe to be at risk.
    - 1.2. **Preservation Worthy.** See discussion under item 2.2 below.
    - 1.3. **Not Including Market Rate Properties.** Unregulated affordable apartments are discussed in the secondary recommendation.

2. **Preservation Transaction.** Tax relief to the seller will be granted only when the property is eligible, preserved under sustainability principles, with a long-term use agreement, and in the hands of a preserving entity, all as certified by the State HFA. See the background paper for an expanded discussion of these conditions.

2.1. **Certifying Entity.** The Task Forces recommend that State HFAs certify transactions as "preservation transactions" and that this certification be a precondition for the seller's eligibility for tax relief.

2.2. **Eligible.** The State HFA would establish the property's eligibility.

2.2.1. **Troubled Properties Must Be Cured.** HFAs would screen out troubled properties except where the purchaser proposes interventions sufficient to overcome the problems.

2.2.2. **High Value Properties Are Eligible.** The Task Forces recognize that it will not always be good public policy to preserve the highest-value properties that are now affordable but that can terminate affordability and increase rents dramatically. However, the Task Forces intend that State HFAs make that decision on a case by case basis.

2.3. **Sustainable.** The property is structured and financed so that its financial and physical viability can be maintained for an extended period such as fifty years, without the need for periodic injection of additional government subsidies.

2.3.1. **Period of Sustainability.** The Preservation Task Force elsewhere recommends a fifty-year sustainability period for most subsidized rental housing properties. See the background paper on Long Term Sustainability and Affordability. The Task Forces believe that fifty years will be appropriate for most transactions but recommend that State HFAs be allowed to certify "preservation transactions" with sustainability periods of at least thirty years.

2.4. **Use Agreement.** A covenant running with the land, providing for maximum rents, occupancy restricted by household income, and other appropriate commitments consistent with affordability over an extended period at least as long as the period of sustainability.

2.4.1. **Maximum Rents.** The Task Forces believe that maximum rents of 30% of 60% AMI will be appropriate for most properties but recommend that State HFAs be allowed to certify "preservation transactions" with maximum rents up to 30% of 80% AMI (for example, to conform with pre-preservation-transaction subsidy contracts).

2.4.2. **Household Incomes.** The Task Forces believe that maximum household income at 60% AMI will be appropriate for most properties but recommend that State HFAs be allowed to certify "preservation transactions" with maximum incomes up to 80% AMI (for example, to conform with pre-preservation-transaction subsidy contracts).

2.4.3. **Transition.** The rent restriction will apply immediately after purchase. The household income restriction will apply to move-ins after purchase.

2.5. **Preserving Entity.** The purchaser must have the capability to acquire, finance and operate the property as affordable housing and must accept the use agreement.

3. **Full Relief.** The Task Forces recommend that sellers receive full relief from the tax on minimum gain. This would be accomplished by excluding from taxable income the full amount of the minimum gain (subject to phase-out provisions as discussed later).

3.1. **Rationale For Full Relief.** The Task Forces find that, from a real estate transactional standpoint, full relief has a very large advantage over partial relief. The Task Forces find that typical partnership agreements require 66% to 100% of partners to consent to a sale. Accordingly, a sale must be distinctly favorable in order to gain approval. Full relief is much easier to explain to investors and thus much more likely to gain approval. The Task Forces also find that it is not possible, as a practical matter, to calculate a finely calibrated "point of indifference" because of the very wide variety of property situations and investor personal tax situations.

3.2. **Relief Based on Affordable Units.** The seller's tax relief is based only on the units that are covered by the long-term use agreement. The Task Forces believe that most sellers and purchasers will restrict 100% of the units.

3.3. **Alternative 1: 70% Relief.** The Task Forces recognize that there is uncertainty whether full relief is necessary. If the Commission decides to recommend partial relief, the Task Forces recommend that the level of relief be well above the 40% level (net present value) that the Task Forces find is likely to be a theoretical "point of indifference" for some potential sellers. While recommending full relief, the Task Forces suggest 70% relief (halfway between the theoretical minimum and full relief) in the event the Commission decides against full relief.

3.4. **Alternative 2: 70% to 100% Relief.** The Commission could recommend a threshold of 70% relief, with 100% relief being available for preservation transactions meeting appropriate additional affordability objectives determined by the State HFA.

4. **First Come First Served.** The Task Forces recommend that sellers be granted relief on a first come first served basis.

4.1. **Rationale.** The Task Forces desire a mechanism for managing the cost of the incentive but wish to provide predictability to sellers and purchasers.

4.2. **Ceiling.** The Task Forces recommend a program ceiling sufficient to allow preservation of at least 500,000 units nationally, consistent with the background paper's estimate of the potential universe of likely transactions.

4.3. **Certifying Agency.** The Task Forces recommend that State HFAs certify transactions as preservation transactions and that the IRS allocate the incentive based upon the HFA certification. See the discussion on page 10 of the background paper.

5. **Program Term.** The Task Forces recommend that the Internal Revenue Code be permanently amended to provide the incentive but that the availability of the incentive be subject to the ceiling discussed above. Notwithstanding the preceding, the Task Forces anticipate that the great bulk of the preservation transactions will occur within five to ten years after enactment.

6. **Phase-Out For More Valuable Properties.** The Task Forces recommend full relief for properties for which the seller receives no consideration over and above relief from the existing indebtedness. The Task Forces recommend phase-out of the incentive for other properties.

6.1. **Phase-Out Based On Net Sales Proceeds.** The Task Forces recommend that, for each dollar of net sales proceeds, the amount of minimum gain excluded from taxable income under the incentive be reduced by one dollar.

6.2. **Phase-Out Based on Charitable Donation Deduction.** The Task Forces recommend that, for properties for which the seller claims a charitable contribution deduction, the amount of minimum gain excluded from taxable income under the incentive be reduced by one dollar for each dollar of charitable contribution deduction.

6.3. **Maximum Phase-Out.** The Task Forces recommend that the maximum phase-out be set at two-thirds, so that a preservation transaction is always economically superior to the seller, by comparison to any other sale transaction.

Secondary Recommendation:

7. **Preservation Tax Incentive for Unregulated Affordable Apartments.** The Task Forces recommend extending eligibility for the preservation tax incentive to sellers of certain unregulated (market rate) properties, on the same terms outlined above, except as follows:
    7.1. **Use Agreement.** The long-term use agreement will provide for maximum rents not to exceed 30% of 60% of AMI, and household incomes not to exceed 60% AMI.
    7.2. **Eligible Units.** As with the primary recommendation, the seller will be eligible for relief only with respect to units whose rents are restricted under the long-term use agreement. The Task Forces anticipate that most sellers and purchasers will decide to rent-restrict 100% of the units.
    7.3. **Voucher Holders.** The preserving entity will agree that 20% of the total units will be available to voucher holders and that at least 10% of the total units will be occupied by voucher holders.
    7.4. **Eligible Properties.** Properties must be at least 20 years old and must be in low-poverty areas.
    7.5. **Ceiling.** These properties will be subject to the same statutory ceiling on total transactions. State HFAs may decide whether to prioritize assisted vs. market rate properties.